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# The Federal Reserve's Catch-22: A Legal Analysis of the Federal Reserve's Emergency Powers

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## **The Federal Reserve's Catch-22:<sup>1</sup> A Legal Analysis of the Federal Reserve's Emergency Powers**

### **I. INTRODUCTION**

The federal government's role in the buyout of The Bear Stearns Companies (Bear) by JPMorgan Chase (JPMorgan) will be of lasting significance because it shaped a pivotal moment in the most threatening financial crisis since The Great Depression.<sup>2</sup> On March 13, 2008, Bear informed "the Federal Reserve and other government agencies that its liquidity position had significantly deteriorated, and it would have to file for bankruptcy the next day unless alternative sources of funds became available."<sup>3</sup> The potential impact of Bear's insolvency to the global financial system<sup>4</sup> persuaded officials at the Federal Reserve (the Fed) and the United States Department of the Treasury (Treasury) to take unprecedented regulatory action.<sup>5</sup> The response immediately

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1. JOSEPH HELLER, CATCH-22 (Laurel 1989).

2. See *Turmoil in the Financial Markets: Testimony Before the H. Oversight and Government Reform Comm.*, 110<sup>th</sup> Cong. -- (2008) [hereinafter *Greenspan Testimony*] (statement of Dr. Alan Greenspan, former Chairman, Federal Reserve Board of Governors) ("We are in the midst of a once-in-a century credit tsunami."); Niall Ferguson, *Wall Street Lays Another Egg*, VANITY FAIR, Dec. 2008, at 190, available at <http://www.vanityfair.com/politics/features/2008/12/banks200812> ("[B]eginning in the summer of 2007, [the global economy] began to self-destruct in what the International Monetary Fund soon acknowledged to be 'the largest financial shock since the Great Depression.'"); Jeff Zeleny and Edmund L. Andrews, *Obama Warns of Prospect for Trillion-Dollar Deficits*, N.Y. TIMES, Jan. 7, 2009, at A1 ("When the American people spoke last November, they were demanding change – change in policies that helped deliver the worst economic crisis that we've seen since the Great Depression[.]").

3. *Turmoil In U.S. Credit Markets: Examining The Recent Actions of Federal Financial Regulators: Panel I of a Hearing of the S. Banking, Housing and Urban Affairs Comm.*, 110<sup>th</sup> Cong. -- (2008) [hereinafter *Panel I Hearings*] (statement of Ben Bernanke, Chairman, Federal Reserve Board of Governors).

4. *Id.* (statement of Sen. Christopher Dodd, D-CT) ("[C]onsidering everything that was on the table in the closing hours on that Sunday, that the alternative – and I don't think this is hyperbole – could have been devastating, both at home and around the world for that matter.").

5. See, e.g., Michel G. Crouhy, Robert A. Jarrow & Stuart M. Turnbull, *The Subprime Credit Crisis of 2007*, 16.1 J. DERIVATIVES 81, 104 n.5 (2008) ("To smooth the deal, the Fed has taken the *unprecedented* step of providing US\$30 billion in

redefined market expectations for monetary policy in an economic crisis.<sup>6</sup> The legal basis for this marked departure from the Fed's established sphere of operations<sup>7</sup> warrants scrutiny.<sup>8</sup>

The Federal Reserve System was created after "[a] particularly severe crisis in 1907 prompted Congress to establish the National Monetary Commission, which put forth proposals to create an institution that would help prevent and contain financial disruptions of this kind."<sup>9</sup> Given this auspicious mandate, it is

financing for Bear Stearns' less liquid assets." (emphasis added)); Greg Ip, *Fed Invokes Depression-Era Law for Bear Loan*, WALL ST. J., Mar. 14, 2008, <http://blogs.wsj.com/economics/2008/03/14/fed-invokes-depression-era-law-for-bear-loan/> (discussing how rarely the Fed has resorted to this provision of the Federal Reserve Act); BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS 46 (9<sup>th</sup> ed. 2005), available at [http://www.federalreserve.gov/pf/pdf/pf\\_complete.pdf](http://www.federalreserve.gov/pf/pdf/pf_complete.pdf) [hereinafter PURPOSES & FUNCTIONS] ("The Federal Reserve also has the authority under the Federal Reserve Act to extend credit to entities that are not depository institutions in 'unusual and exigent circumstances'; however, such lending has not occurred since the 1930s.").

6. See Craig Torres, *Bernanke Discards Monetary History with Bear Stearns Bailout*, BLOOMBERG.COM, Mar. 15, 2008, [http://www.bloomberg.com/apps/news?pid=20601087&sid=aY2RvFA.yO\\_Q&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=aY2RvFA.yO_Q&refer=home) (discussing the policy implications of "moral hazard" relative to the risk of systemic collapse). See also Press Release, U.S. Dep't of the Treasury, Henry M. Paulson, Jr., Sec'y, U.S. Dep't of the Treasury, Remarks on Current Financial and Housing Markets at the U.S. Chamber of Commerce (Mar. 26, 2008), available at <http://www.treas.gov/press/releases/hp887.htm> ("Recent market conditions are an exception from the norm. At this time, the Federal Reserve's recent action should be viewed as precedent only for unusual periods of turmoil."); Tom Curry, *Crisis Illustrates Power of the Unelected: For a Few Days, at Least, Bernanke Eclipses Clinton, Obama and McCain*, MSNBC.COM, Mar. 17, 2008, <http://www.msnbc.msn.com/id/23673053/> (testimony of Sen. Charles Schumer, D-N.Y.) ("What's just as important as standing behind Bear Stearns is the idea that they will stand behind other institutions . . ."); *The Today Show* (NBC television broadcast Mar. 18, 2008), available at <http://www.msnbc.msn.com/id/21134540/vp/23687543#23687543> ("Has the government set a precedent for propping up failing financial institutions at a time when its more traditional tools don't appear to be working?").

7. See generally PURPOSES & FUNCTIONS, *supra* note 5, at 27-50 (describing the traditional tools employed by the Fed to promulgate monetary policy).

8. *Panel I Hearings*, *supra* note 3 (statement of Sen. Christopher Dodd, D-CT) ("Given these considerations and the highly unusual and unprecedented actions taken by the Federal Reserve Board of Governors, the Federal Reserve Bank of New York and the support of the Department of Treasury, I believe it is appropriate – indeed, essential that this committee, the Banking Committee, exercise its oversight and investigatory functions to examine the authority, economic justification and the public policy implications of these extraordinary recent actions by our nation's federal financial regulators.").

9. See PURPOSES & FUNCTIONS, *supra* note 5, at 1-2. But see David Fetting, *Lender of More Than Last Resort*, Dec. 2002, [http://www.minneapolisfed.org/publications\\_papers/pub\\_display.cfm?id=3392](http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3392) ("And it's also not clear that there was always a lot of certainty about the Fed's original character. The following quotation is

perhaps surprising that the Fed's original emergency powers were quite modest under the Federal Reserve Act of 1913 (the Act).<sup>10</sup> However, amendments in 1932<sup>11</sup> and 1991<sup>12</sup> to § 13(3) of the Act gave the Fed the ability to lend freely to non-banking institutions in "unusual and exigent circumstances."<sup>13</sup> This statutory authority made each action taken in the Bear bailout legally defensible.<sup>14</sup> In addition, the statutory construction has not been limited by judicial review as the courts have largely shied away from developing jurisprudence that interprets monetary policy.<sup>15</sup> Accordingly, only Congress has the power to revise or otherwise limit the Fed's power.<sup>16</sup>

Part II will discuss general economic and market conditions that contributed to Bear's swift fall, highlight key events in the Bear story, and discuss the rationale articulated by officials in support of their decision to act.<sup>17</sup> Part III will present analysis that supports the legality of the particular actions taken by the

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from the Minneapolis Fed's 1921 Annual Report: 'More than seven years have elapsed since the establishment of the Federal Reserve Banks, but there is still a surprising lack of knowledge of what they really are and of what their proper functions are[.]'').

10. Federal Reserve Act, 12 U.S.C. §§ 221—522 (2006); *see also* Fettig, *supra* note 9.

11. 12 U.S.C. § 343 (2006) (originally enacted as Act of July 21, 1932) (The 1932 amendment is codified in the second paragraph of § 343); *see also* Fettig, *supra* note 9 ("[T]he 1932 amendment is only meant to address crisis situations.").

12. 12 U.S.C. § 343 (amended by Pub.L. 102-242). Section 473 of the Federal Deposit Insurance Corporation Improvement Act of 1991 negated collateral restrictions on emergency borrowing at the discount window, putting non-banking institutions on the same footing as banks for the first time under § 13(3). Prior to this amendment, major securities firms were effectively foreclosed from using emergency credit because the Fed could not lend against securities, which constituted the bulk of their assets. *See* Fettig, *supra* note 9; Walker F. Todd, *FDICIA's Emergency Liquidity Provisions*, 29.3 ECONOMIC REVIEW - FEDERAL RESERVE BANK OF CLEVELAND 16, 16, 19 (1993), *available at* <http://www.clevelandfed.org/Research/Review/1993/1993-q3.pdf>.

13. 12 U.S.C. § 343 (2006).

14. *See infra* notes 148 – 205 and accompanying text.

15. *See* Raichle v. Fed. Reserve Bank of New York, 34 F.2d 910, 915 (2d Cir. 1929) ("It would be an unthinkable burden upon any banking system if its open market sales and discount rates were to be subject to judicial review.").

16. *Id.*

17. *See infra* notes 20-114 and accompanying text.

regulators.<sup>18</sup> Part IV will raise policy issues concerning the Fed's decision to invoke § 13(3) in the Bear bailout.<sup>19</sup>

## II. UNDERPINNINGS OF THE PRESENT FINANCIAL CRISIS

### A. *Economic Conditions*

The defining feature of the current financial crisis is the protracted constraint of credit.<sup>20</sup> The financial press has popularly titled the economic turmoil, "The Credit Crisis."<sup>21</sup> Nevertheless, constrained credit is a dependent variable, an effect rather than the underlying cause of the financial system's collapse.<sup>22</sup> Lenders' unwillingness to extend credit reflects their inability to reliably evaluate the financial position of borrowers, including other financial institutions.<sup>23</sup> Such pervasive distrust does not arise at once.<sup>24</sup> The meltdown of the subprime mortgage market in August

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18. See *infra* notes 115-205 and accompanying text.

19. See *infra* notes 206-235 and accompanying text.

20. *Financial Markets: Hearing Before the S. Banking, Housing and Urban Affairs Comm.*, 110<sup>th</sup> Cong. -- (2008) (testimony of Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York, [hereinafter *Geithner Testimony*] ("Market participants' willingness to provide term funding even against high-quality collateral declined dramatically. As a consequence, the cost of unsecured term funding rose precipitously and the volume shrunk . . . if this dynamic continues unabated, the result would be a greater probability of widespread insolvencies, severe and protracted damage to the financial system and, ultimately, to the economy as a whole. This is not a theoretical risk, and it is not something that the market can solve on its own.")).

21. See, e.g., GEORGE SOROS, *THE NEW PARADIGM FOR FINANCIAL MARKETS: THE CREDIT CRISIS OF 2008 AND WHAT IT MEANS* xxi (PublicAffairs 2008); Crouhy, Jarrow & Turnbull, *supra* note 5 *passim*.

22. See Katie Benner, *I Was Lucky to Get Out*, CNNMONEY.COM, Sept. 26, 2008, [http://money.cnn.com/2008/09/24/news/newsmakers/benner\\_callan.fortune/index.htm](http://money.cnn.com/2008/09/24/news/newsmakers/benner_callan.fortune/index.htm) (interview with Erin Callan, former Chief Financial Officer, Lehman Brothers Inc.) ("The question about why within a day a bank's borrowing cost could double; that's the heart of the matter. It's not that somebody decides overnight that a bank is twice as risky. They wonder if their entire view was misplaced. They wonder whether these types of organizations without deposit bases should borrow at these kinds of rates. That worry stems from a lack of confidence in the institution.").

23. Crouhy, Jarrow & Turnbull, *supra* note 5, at 95 ("[The] [a]bsence of complete and timely data and concern about valuation methodologies . . . made investors uncertain about valuations posted by banks in their trading books[.]").

24. *Id.* at 91-94. The authors describe the fair value accounting framework, under which "nonstandard instruments" are valued pursuant to a three-tier scheme: "Level 1 – clear market prices; Level 2 – valuation using prices of related instruments; and Level 3 – prices cannot be observed and model prices need to be used." Model prices are theoretical and sensitive to input data and assumptions. U.S. banks reported a

2007 is commonly identified as the origin of the financial crisis and the basis on which mistrust and uncertainty first began to breed.<sup>25</sup>

Before the recent turmoil, however, the subprime market saw enormous growth in post-millennia America.<sup>26</sup> This growth was largely fueled by credit expansion.<sup>27</sup> The “credit boom”<sup>28</sup> was itself a function of immediate monetary stimulus<sup>29</sup> as well as broader historical conditions tying back to the end of the Cold War.<sup>30</sup> To the first point, the collapse of the “dot-com bubble”<sup>31</sup> in 2000 and the September 11th terrorist attacks urged the Fed to reduce the federal funds rate<sup>32</sup> (the “discount rate”) to its lowest level since World War II.<sup>33</sup> Former Fed Chairman, Alan Greenspan, has stated that this monetary policy was viable

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40% increase (\$96 billion) in Level 3 assets in the first quarter of 2008. Reported values engendered a great deal of uncertainty in the marketplace. *Id.* at 91-94.

25. See, e.g., *Greenspan Testimony*, *supra* note 2.

26. See Kathleen C. Engel & Patricia A. McCoy, *Turning A Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2045 (2007) (“By the early 1990s, technological advances made it possible to estimate and price the risk of subprime home loan pools, paving the way for subprime securitizations. In 2005, total securitizations of subprime and home equity loans ballooned to an estimated \$525.7 billion.”).

27. See Soros, *supra* note 21, at 82-83.

28. *Panel I Hearings*, *supra* note 3 (statement of Ben Bernanke, Chairman, Federal Reserve Board of Governors) (“There was a substantial credit boom that peaked last summer. That credit boom, which was driven by international factors . . .”).

29. See Mark Gongloff, *Tech's Tumble Is Bad News for All Stocks*, WALL ST. J., Sept. 30, 2008, at C1.

30. See *Charlie Rose: A Conversation with Alan Greenspan* (PBS television broadcast Sept. 20, 2007), available at <http://www.charlierose.com/view/interview/8704> [hereinafter *Charlie Rose*] (“I was confronted with a major global determined decline in long-term interest rates and inflation expectations . . . this is essentially the result of the end of the Cold War[.]”).

31. See Gongloff, *supra* note 29.

32. PURPOSES & FUNCTIONS, *supra* note 5, at 27 (“[A] target for the interest rate at which [deposits held by depository institutions at Federal Reserve Banks] are traded between depository institutions.”).

33. Soros, *supra* note 21, at xv, 82 (noting that the inflation-adjusted fed funds rate was negative for almost three years such that the lender was, in effect, paying the borrower to hold the loan); see also WILLIAM A. FLECKENSTEIN & FREDERICK SHEEHAN, *GREENSPAN'S BUBBLES: THE AGE OF IGNORANCE AT THE FEDERAL RESERVE* (McGraw Hill 2008) (providing a critique of Greenspan's monetary policy at the helm of the Federal Reserve); Curry, *supra* note 6 (statement of Sen. Jim Bunning, R-Ky) (“Chairman Greenspan leaves knowing that his mess will fall to his apprentice, Ben Bernanke. I hope there is no damaging recession or financial crisis looming. If so, I hope Ben Bernanke does not live up to his nickname of ‘Helicopter Ben,’ and throw the U.S. mint's printing presses into overdrive.”).

because of the reduced risk of inflation as a result of the end of the Cold War.<sup>34</sup> In addition, public policy during this period promoted home ownership among Americans.<sup>35</sup>

From this historical context, housing surged to the extent that it began to prop up the entire economy: “Merrill Lynch estimated that about half of all American GDP growth in the first half of 2005 was housing related, either directly, through home building and housing-related purchases like new furniture, or indirectly, by spending the cash generated from the refinancing of mortgages.”<sup>36</sup> Mortgage markets experienced parallel growth, benefiting directly from “rising home prices, low interest rates, increased competition among lenders, and a wealth of capital from lenders and mortgage securities investors.”<sup>37</sup> However, these market conditions also betray an insidious “system of incentives that channeled the greed”<sup>38</sup> fueling the housing bubble.<sup>39</sup>

Wall Street’s primary role is to allocate capital efficiently between participants in the marketplace and within the financial system generally.<sup>40</sup> In return for performing this function, Wall Street firms earn fees on the movement of capital, namely the

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34. Compare *Charlie Rose*, *supra* note 30, with *Greenspan Testimony*, *supra* note 2 (arguing the present crisis arose in part because of the “protracted period of underpricing [sic] of risk” but declining to attribute this misperception to the effect of monetary policy).

35. Melissa B. Jacoby, *Home Ownership Risk Beyond a Subprime Crisis: The Role Of Delinquency Management*, 76 *FORDHAM L. REV.* 2261, 2261 & n.1 (2008) (“Commentators often cite three justifications for investing in and promoting home ownership: (1) it builds household wealth and economic self-sufficiency; (2) it generates positive social-psychological states; and (3) it fosters stable neighborhoods and communities.”) (citing Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government’s Promotion of Home Equity Financing*, 69 *TUL. L. REV.* 373, 374 n.1, 406 n.177 (1994)); Steven A. Holmes, *Fannie Mae Eases Credit to Aid Mortgage Lending*, *N.Y. TIMES*, Sept. 30, 1999, at C2 (discussing policy decision to increase mortgage availability to more risky borrowers).

36. Soros, *supra* note 21, at xv n.1 (citation omitted).

37. See, e.g., *Backgrounder on Subprime Lending*, Research Solutions (LexisNexis), 2007, available at [http://www.lexisnexis.com/documents/pdf/20080104111942\\_large.pdf](http://www.lexisnexis.com/documents/pdf/20080104111942_large.pdf).

38. Michael Lewis, *The End*, *PORTFOLIO*, Dec. 2008, <http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/11/The-End-of-Wall-Streets-Boom>.

39. See, e.g., Crouhy, Jarrow & Turnbull, *supra* note 5, at 95 (listing fourteen factors that helped create the credit crisis); *A Mortgage Fable*, *WALL ST. J.*, Sept. 22, 2008, at A22 (arguing that regulators helped shape incentives for Wall Street and market participants that led to the financial system’s collapse).

40. See, e.g., Lewis, *supra* note 38 (“The essential function of Wall Street is to allocate capital—to decide who should get it and who should not.”).

transactions they service.<sup>41</sup> Like brokers in any industry, however, Wall Street's incentive to complete a given transaction does not always align with the incentives of the principals involved in the deal.<sup>42</sup> This potential for dissonance was exacerbated over the last two decades by the growth of securitization and derivative financial instruments that allowed third parties to make bets and generate profits somewhat independent of the underlying transaction or asset.<sup>43</sup> At the same time, Wall Street firms were allocating a growing percentage of their own capital to proprietary trading and investments.<sup>44</sup> Firms turned to these riskier sources of revenue, amplified by leverage, to compete in an increasingly competitive market as public corporations beholden to short-term profits.<sup>45</sup>

Wall Street used asset-backed securities as one way to allocate capital between borrowers and lenders, investors and issuers.<sup>46</sup> The money supply, greatly expanded by the Fed in response to prior economic downturns, created demand on the buy side as investors sought "instruments . . . offer[ing] yield enhancement."<sup>47</sup> Asset-backed securities promised attractive risk-

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41. Ferguson, *supra* note 2.

42. See Lewis, *supra* note 38.

43. See, e.g., Jongho Kim, *From Vanilla Swaps to Exotic Credit Derivatives: How to Approach the Interpretation of Credit Events*, 13 FORDHAM J. CORP. & FIN. L. 705, 706 (2008) ("'[F]inancial engineering' of the present era succeeds in creating new value through the highest levels of statistical analysis, in many ways actually creating something from nothing.").

44. Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 409 (2002).

45. *Id.* at 227-247, 312-321, 407-415 (presenting a broad overview of the challenges to the tradition banking model over the last thirty years and the financial services industry's dangerous responses); see also Lewis, *supra* at note 38 ("Nor can you tell [John Gutfreund] that you asked him to lunch because you thought that you could trace the biggest financial crisis in the history of the world back to a decision he had made . . . when he turned Salomon Brothers from a private partnership into Wall Street's first public corporation . . . [h]e and the other partners not only made a quick killing; they transferred the ultimate financial risk from themselves to their shareholders. It didn't, in the end, make a great deal of sense for the shareholders . . . [n]o investment bank owned by its employees would have levered itself 35 to 1 or bought and held \$50 billion in mezzanine C.D.O.'s . . . the hoped-for short-term gain would not have justified the long-term hit.").

46. Crouhy, Jarrow & Turnbull, *supra* note 5, at 82-83.

47. *Id.* at 82; Soros, *supra* note 21, at xv ("Cheap money engendered a housing bubble...Investment banks on Wall Street developed a variety of new techniques to hive credit risk off to other investors[.]").



adjusted returns by diffusing “default risk an inch deep and a mile wide.”<sup>48</sup> These securities were built on the principle that the default risk of a given loan could be diversified away by pooling thousands of loans together into a security representing a claim to a portion of the expected future cash flows of all the loans.<sup>49</sup>

Structured finance is not a new concept and has been used successfully across many asset classes.<sup>50</sup> When used prudently, asset securitization can mitigate the cost of debt for borrowers and provide a low risk return for investors.<sup>51</sup> In this boom, however, the virtues of securitization were challenged by excess.<sup>52</sup> For instance, mortgages were not only pooled together and securitized once, but other securities known as collateralized debt obligations (CDOs) were created from the riskiest tranches of the original securities.<sup>53</sup> Even these second order securitizations, “which embed leverage within their structure” to enhance returns, often

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48. Serena Ng & Henry Sender, *Behind Buyout Surge, A Debt Market Booms*, WALL ST. J., June 26, 2007, at A1 (explaining how Wall Street securitized several different asset classes, including mortgages, by pooling the assets and their future cash flows together and then slicing the pool into tranches according to risk. Securities were then sold to investors according to risk profile and ostensibly priced off of the underlying assets.); see also Engel & McCoy, *supra* note 26, at 2057 (discussing the diversification of risk for investors through securitization).

49. See Engel & McCoy, *supra* note 26, at 2040, 2057; cf., Joseph R. Mason & Joshua Rosner, *Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities an Collateralized Debt Obligation Market Disruptions*, (Hudson Inst., Working Paper, May 14, 2007), available at <http://ssrn.com/abstract=1027475> (“[T]he distinction between risk pooling, risk sharing, and diversification . . . one of the primary myths perpetuated on Wall Street is that mortgage pools are diversified.”).

50. Wilmarth, *supra* note 44, at 238 (“Improvements in information technology since 1980 have enabled securities firms to transform a wide array of consumer loans into asset-backed securities, including financial instruments backed by pools of credit card receivables, home mortgages, and motor vehicle loans and leases.”); Engel & McCoy, *supra* note 26, at 2045-2048.

51. Crouhy, Jarrow & Turnbull, *supra* note 5, at 103 (“Securitization allows banks to move assets off their balance sheets, freeing up capital and spreading the risk among many different players. These are real benefits.”); cf., Michael R. Sesit, *Smart Investors Have to Wonder Who’s Dumb Now*, BLOOMBERG.COM, Aug. 22, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aK7GbFbB2OHc> (discussing how financially “sophisticated investors” were also duped by exotic financial instruments, but acknowledging that these instruments do still have benefits when used correctly).

52. Soros, *supra* note 21, at xiv-xxiv, 82-91 (discussing generally the conditions underlying the housing bubble); *Greenspan Testimony*, *supra* note 2 (concluding securitization created a significant degree of “excess demand” in the home mortgage markets, the source of the crisis).

53. See, e.g., Lewis, *supra* note 38.

received triple-A ratings.<sup>54</sup> Inexpensive capital and the pervasive assumption that home values would continue to appreciate encouraged both the securitization of loans to increasingly risky borrowers on the supply side and the systematic mispricing of risk on the buy side.<sup>55</sup> Within this mirage, institutional investors, among others, crowded the subprime market to capture the promised yields.<sup>56</sup>

In hindsight it seems obvious that a security based on aggregated loans to shaky borrowers cannot eliminate risk simply through financial machinations.<sup>57</sup> Yet structural blinds in the system, namely the effect of secondary markets “transferring ownership of mortgages from bankers who knew their customers to investors who did not[,]”<sup>58</sup> and perverse incentives<sup>59</sup> allowed misperceptions to persist.<sup>60</sup> Eventually, the collective illusion was

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54. Crouhy, Jarrow & Turnbull, *supra* note 5, at 82.

55. *Id.* at 85 (“Investors in complex credit products had considerably less information at their disposal to assess the underlying credit quality of the assets they held in their portfolios than the originators. As a result, these end-investors often came to rely heavily on the risk assessments of rating agencies.”).

56. *Id.* at 84-85 (“The pressure to increase the supply of subprime mortgages arose because of the demand by investors for higher yielding assets . . . [m]any investor are restricted to investing in assets with certain ratings . . . money market funds are restricted to investing only in triple-A assets, and pension funds and municipalities are restricted to investing in investment-grade assets[.]”).

57. See Lewis, *supra* note 38 (“In retrospect, pretty much all of the riskiest subprime-backed bonds were worth betting against; they would all one day be worth zero. But at the time Eisman began to do it, in the fall of 2006, that wasn’t clear.”); *Fresh Air* (NPR radio broadcast Sept. 17, 2008) (transcript available at <http://www.npr.org/templates/story/story.php?storyId=94686428>) (statement by law professor Michael Greenberger) (“[A]ll these financial instruments . . . are built around the hope that people who can’t afford their mortgages will somehow be able to pay them . . .”).

58. SOROS, *supra* note 21, at xvii.

59. See Judith Burns, *Under Review for Revamp: The Credit-Ratings Firms*, WALL ST. J., Mar. 22, 2008, at A11; Michael Hudson, *How Wall Street Stoked the Mortgage Meltdown*, WALL ST. J., June 27, 2007, at A1 (“[M]ortgage applications with little documentation were vulnerable to misrepresentation or overestimation of repayment capacity by both lenders and borrowers.”); Mason & Rosner, *supra* note 49, at 17 (“These models were created in close cooperation with the investment banks that structured CDOs.”); Lewis, *supra* note 38 (alleging that the financial models used by Standard & Poor’s (one of the two primary ratings agencies) to calculate ratings for these debt securities were incapable of processing a negative growth assumption for real estate prices).

60. Crouhy, Jarrow & Turnbull, *supra* note 5, at 85 (“The argument could be made that as the yields on these instruments exceeded those on equivalently rated corporations, the market knew they were not of the same credit and/or liquidity risk. But investors still misjudged the risk.”); Engel & McCoy, *supra* note 26, at 2046-2063

shattered by economic fundamentals.<sup>61</sup> A glut of supply arrested the rise in home prices, creating enough downward pressure to burst the asset bubble.<sup>62</sup> As home prices began to fall, borrowers found it difficult to refinance mortgages.<sup>63</sup> This effect was especially harmful to subprime borrowers, many of whom held varieties of “adjustable rate mortgages”<sup>64</sup> that reset to high rates after an initial borrowing period and had negative amortization.<sup>65</sup> When housing prices were rising, a borrower who could not afford the monthly payment after the interest rate reset (sometimes even before reset) could often refinance the mortgage based on the higher appraised value of the property.<sup>66</sup> With this option eliminated, the number of borrower defaults quickly began to increase and mortgage-backed securities began to lose appreciable value.<sup>67</sup> As with any asset bubble, sell-offs intensified downward pressure as investors tried to exit their investments before value declined further.<sup>68</sup>

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(explaining how conservative risk estimates by ratings agencies and credit default swap protection were factors that contributed to investor appetite).

61. See Alia McMullen, *Shrinking Supply Needed to Help End U.S. Housing Slump*, FINANCIALPOST.COM, Aug. 19, 2008, <http://www.financialpost.com/story.html?id=734895>; accord Croughy, Jarow & Turnbull, *supra* note 5, at 83 (noting the delinquency rates for subprime mortgages began to rise in 2005 because of increasingly aggressive mortgage structures, increase in short-term interest rates, decrease in the rate of home price appreciation, and even greater slack in mortgage origination credit standards).

62. See McMullen, *supra* note 61; accord Croughy, Jarow & Turnbull, *supra* note 5, at 83.

63. See generally James R. Hagerty & Ruth Simon, *Housing Pain Gauge: Nearly 1 in 6 Owners ‘Under Water’*, WALL ST. J., Oct. 8, 2008, at A5 (“[I]t is hard for borrowers in financial trouble to refinance or sell their homes and pay off their mortgage if their debt exceeds the home’s value.”).

64. Soros, *supra* note 21, at xvi.

65. *Id.* See generally Engel & McCoy, *supra* note 26 (discussing the negative externalities created by subprime lending on borrowers).

66. See Michael M. Phillips, *Would You Pay \$103,000 For This Arizona Fixer-Upper? That Was Ms. Halterman’s Mortgage on It; ‘Unfit for Human Occupancy,’ City Says*, WALL ST. J., Jan. 3, 2009, at A1 (providing an extreme account of subprime lending and securitization).

67. See *Geithner Testimony*, *supra* note 20 (“The deterioration in the U.S. housing market late in the summer of 2007 precipitated a sharp rise in uncertainty about the value of securitized or structure assets. Demand for those assets contracted dramatically . . . [t]his, in turn, increased funding pressures for a diverse mix of financial institutions.”); see also Croughy, Jarow & Turnbull, *supra* note 5, at 105 n.19 (citing research demonstrating a “negative correlation between home price appreciation and subprime delinquency rate.”).

68. See *Geithner Testimony*, *supra* note 20; Croughy, Jarow & Turnbull, *supra*

*B. Bear's Lead Role*

Bear was at the center of the financial crisis well before the firm's own demise in March 2008.<sup>69</sup> In the summer of 2007, one of Bear's two proprietary hedge funds, focused on bets in the subprime mortgage market, collapsed as the value of mortgage-backed securities quickly declined with rising borrower defaults.<sup>70</sup> In order to preserve the firm's reputation on Wall Street, Bear lent \$3.2 billion to the fund to prop it up long enough for an orderly liquidation.<sup>71</sup> Nevertheless, the fund's failure indelibly pressed Bear onto the minds of investors and the media alike.<sup>72</sup> The implosion of the Bear fund popularly marks the beginning of the Credit Crisis.<sup>73</sup>

In early March 2008, the rumors took on a new focus.<sup>74</sup> Concerns spread quickly that Bear's liquidity position was compromised.<sup>75</sup> Of particular significance, Goldman Sachs and Credit Suisse sent mass internal e-mails implicating Bear's counter-party risk,<sup>76</sup> hedge funds began exiting Bear's prime

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note 5, at 105 n.19.

69. See Kate Kelly & Serena Ng, *Bear Stearns Bails out Fund with Big Loan*, WALL ST. J., June 23, 2007, at A1.

70. *Id.* (providing an overview of the collapse of Bear Stearns' High-Grade Structured Credit Strategies Fund and High-Grade Structured Credit Enhanced Leverage Fund and the firm's response); see also Bryan Burrough, *Bringing Down Bear Stearns*, VANITY FAIR, Aug. 2008, at 106, available at [http://www.vanityfair.com/politics/features/2008/08/bear\\_stearns200808](http://www.vanityfair.com/politics/features/2008/08/bear_stearns200808) (noting that Bear deliberately chose to focus funds on a single type of investment instead of developing a diversified portfolio, contrary to conventional thinking).

71. Kelly & Ng, *supra* note 69.

72. Burrough, *supra* note 70 (noting that rumors persisted that Bear's financial position was compromised and may ultimately be forced into bankruptcy).

73. See Soros, *supra* note 21, at xxi (noting that the collapse of the Bear funds was, in effect, the last of several preliminary conditions that triggered the crisis); Ferguson, *supra* note 2; Andrew Ross Sorkin, *Leveraged Planet*, DEALBOOK.BLOGS.NYTIMES.COM, Apr. 2, 2008, <http://dealbook.blogs.nytimes.com/category/special-section-spring-2008/>.

74. See Roddy Boyd, *The Last Days of Bear Stearns*, CNNMONEY.COM, Mar. 31, 2008, [http://money.cnn.com/2008/03/28/magazines/fortune/boyd\\_bear.fortune/](http://money.cnn.com/2008/03/28/magazines/fortune/boyd_bear.fortune/).

75. See *Panel 1 Hearings*, *supra* note 3 (statement of Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York) (relating an allegation that European trading partners had stopped doing business with Bear).

76. See Burrough, *supra* note 70 (discussing the hold-up of "novation" requests at Goldman and Credit Suisse, an indemnity-like agreement used in Wall Street trading when a third-party indemnifies a party to a contract that is concerned about counter-party risk).

brokerage business, and money-market funds reversed positions with exposure to Bear's commercial paper.<sup>77</sup> By Thursday, March 13, 2008, Bear could not find sufficient overnight funding via "repo lenders"<sup>78</sup> to conduct business on Friday.<sup>79</sup>

New York Federal Reserve Bank President Timothy Geithner<sup>80</sup> characterized the larger chain of events that felled Bear as:

[S]imilar to the classic pattern in financial crises. Asset price declines triggered by concern about the outlook for economic performance led to a reduction in the willingness to bear risk and to margin calls. Borrowers needed to sell assets to meet the calls; some highly leveraged firms were unable to meet their obligations and their counterparties responded by liquidating the collateral they held.<sup>81</sup>

Bear's CEO, Alan Schwartz, noted more pointedly: "Due to the stressed condition of the credit market as a whole and the unprecedented speed at which rumors and speculation travel and echo through the modern financial media environment, the rumors and speculation ultimately became a self-fulfilling prophecy."<sup>82</sup> In

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77. See *Panel I Hearings*, *supra* note 3 (statement of Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York).

78. About.com: Investing for Beginners, Repurchase Agreements, <http://beginnersinvest.about.com/lw/Business-Finance/Personal-finance/Repurchase-Agreements.htm> (last visited Jan. 26, 2009) (explaining that "repo" is short for "repurchase agreements" in which the borrower sells securities for cash to a lender and agrees to buy back the securities at a later date).

79. See, e.g., Burrough, *supra* note 70; *Panel I Hearings*, *supra* note 3 (statement of Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York).

80. In November 2008, President-elect Barack Obama nominated Geithner to be the Secretary of the Treasury in the incoming Administration. See Jeff Zeleny, *Obama Unveils Team to Tackle 'Historic' Crisis in Economy*, N.Y. TIMES, Nov. 25, 2008, [http://www.nytimes.com/2008/11/25/us/politics/24obama.html?\\_r=1&scp=5&sq=geithner%20and%20appointment%20and%20secretary%20of%20treasury&st=cse](http://www.nytimes.com/2008/11/25/us/politics/24obama.html?_r=1&scp=5&sq=geithner%20and%20appointment%20and%20secretary%20of%20treasury&st=cse).

81. *Geithner Testimony*, *supra* note 20.

82. *Turmoil In U.S. Credit Markets: Examining The Recent Actions of Federal Financial Regulators: Panel II of a Hearing of the S. Banking, Housing and Urban Affairs Comm.*, 110<sup>th</sup> Cong. (2008) [hereinafter *Panel II Hearings*] (statement of Alan Schwartz, President and Chief Executive Officer, The Bear Stearns Companies).

fact, the SEC did commence ongoing investigations into the role of short-sellers in Bear's collapse.<sup>83</sup>

### C. *Regulatory Response*

In his testimony before Congress on April 3, 2008, Geithner briefly described the two substantive actions taken by regulators in the Bear bailout that are the subject of this note:

(1) the decision on the morning of March 14 to extend a non-recourse loan through the discount window to JPMorgan Chase so that JPMorgan could in turn lend that money to Bear Stearns; (2) the decision on March 16 by JPMorgan Chase and Bear Stearns for JPMorgan Chase to acquire Bear and guarantee certain of its liabilities, along with an agreement in principle that the Federal Reserve Bank of New York would provide certain financing in the context of that acquisition[.]<sup>84</sup>

The March 14 decision was reached after the SEC, the Fed, and Treasury debated the implications of a Bear bankruptcy filing on Friday morning to the financial system.<sup>85</sup> The midnight deal allowed Bear to open on Friday, but it proved insufficient to shore up confidence in the markets during trading that day.<sup>86</sup> Secretary Paulson issued an unexpected ultimatum to Schwartz early Friday evening to find a buyer for Bear by the end of the weekend or else the credit line would be extinguished.<sup>87</sup>

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83. Kara Scannell & Jenny Strasburg, *Hedge Funds Subpoenaed in SEC Probe*, WALL ST. J., July 15, 2008, at C3.

84. *Geithner Testimony*, *supra* note 20.

85. *Id.* (noting the deliberate policy judgment that was made to circumvent the market dynamics that had ostensibly caused Bear's bankruptcy).

86. *See Panel II Hearings*, *supra* note 82 (statement of Alan Schwartz, President and Chief Executive Officer, The Bear Stearns Companies).

87. *See Panel II Hearings*, *supra* note 82 (statement of Alan Schwartz, President and Chief Executive Officer, The Bear Stearns Companies) (commenting on the difference of opinion that arose between Bear executives and government officials as to the meaning of the "28 days" language inserted in the credit agreement on Thursday night); *see also* Burrough, *supra* note 70 (statement of Henry M. Paulson, Jr., Sec'y, U.S. Dep't of the Treasury) ("You've got the weekend to do a deal with J.

Bear worked with financial advisors throughout the weekend to find a white knight.<sup>88</sup> Ultimately, the immediacy of the deadline thwarted all potential buyers except for JPMorgan.<sup>89</sup> However, even management at JPMorgan began to back away from the opportunity as late as Sunday morning.<sup>90</sup> Considering their fiduciary duties to shareholders, JPMorgan CEO, Jamie Dimon, and head of Investment Banking, Steve Black, were alarmed by the risk in the transaction given the overall fragility of the markets and economic climate, the riskiness of their own balance sheet, and the lack of time to conduct due diligence and value Bear's illiquid assets.<sup>91</sup>

Remarkably, regulators still managed to structure a deal before the end of the weekend that was agreeable to JPMorgan.<sup>92</sup> On March 16, JPMorgan announced it would acquire Bear in a stock-for-stock exchange, valuing the firm at approximately \$2 per share.<sup>93</sup> The Federal Reserve Bank of New York agreed to "lend \$29 billion in connection with the acquisition . . . against a portfolio of \$30 billion in assets of Bear Stearns."<sup>94</sup> In addition, JPMorgan agreed to sign a \$1 billion note.<sup>95</sup> Both loans would be made to a Delaware limited liability company (the LLC) set up to house the Bear assets and to be managed by Blackrock Financial Management, Inc.<sup>96</sup> The LLC would be liquidated according to a

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P. Morgan or anyone else you can find. But if you're not done by Monday, we're pulling the plug.").

88. See Burroughs, *supra* note 70 (noting that the premier investment banker in the financial institutions space, Garry Parr of Lazard Freres, was hired by Bear Stearns).

89. *Id.* (commenting that would-be suitors were particularly frightened by the lack of time to conduct customary due diligence).

90. *Id.*

91. *Id.*

92. *Panel II Hearings, supra* note 82 (statement of James Dimon, Chairman and Chief Executive Officer, JPMorgan Chase).

93. Press Release, JP Morgan Chase, JPMorgan Chase to Acquire Bear Stearns (Mar. 16, 2008), *available at* [http://www.jpmorgan.com/cm/Satellite?c=JPM\\_Content\\_C&cid=1159338557604&pagename=JPM\\_redesign%2FJPM\\_Content\\_C%2FGeneric\\_Detail\\_Page\\_Template](http://www.jpmorgan.com/cm/Satellite?c=JPM_Content_C&cid=1159338557604&pagename=JPM_redesign%2FJPM_Content_C%2FGeneric_Detail_Page_Template).

94. Press Release, Federal Reserve Bank of New York, Summary of Terms and Conditions Regarding the JPMorgan Chase Facility (Mar. 28, 2008) [hereinafter Press Release for JPMorgan Facility], *available at* <http://www.ny.frb.org/newsevents/news/markets/2008/rp080324b.html>.

95. *Id.*

96. *Id.*

waterfall that subordinated the JPMorgan loan to that of the Fed, ensuring the New York Fed would be the first to be paid back.<sup>97</sup> Beyond the JPMorgan \$1 billion protection, however, Secretary Paulson's signature meant that the Treasury (implicitly, U.S. taxpayers) was on the hook if Bear defaulted on the loan to the Federal Reserve Bank of New York.<sup>98</sup>

*D. Rationale: "Not too big to fail, too interlinked to fail"*<sup>99</sup>

Regulators' concerns about the fallout from a Bear bankruptcy filing were twofold.<sup>100</sup> First, they believed that Bear's role as an intermediary in the huge market for derivatives trades inextricably linked the firm to thousands of counterparties around the world.<sup>101</sup> "[I]f the middle broker goes down – and neither side has confidence that the paper they hold can be redeemed, then the whole worldwide thing melts down."<sup>102</sup> Second, a bankruptcy filing would flood an already vulnerable market with Bear's illiquid assets at fire sale prices.<sup>103</sup> This would be devastating under the fair value accounting regime governing U.S. institutions.<sup>104</sup> "When

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97. *Id.*

98. Burrough, *supra* note 70 ("At one point, Paulson had to sign a document confirming that, yes, in the event Bear defaulted on its securities, the American taxpayer would pay the tab."); *see also* Todd, *supra* note 12, at 20-21 ("The extension of the federal financial safety net to nonbanks may increase the probability of market liquidity crises that appear to require Federal Reserve emergency lending. This could happen during periods of market stress if the costs of risky investment and funding strategies are not fully borne by the managers and shareholders of nonbank firms, but instead are perceived as being partially or fully underwritten by U.S. taxpayers.").

99. *See Panel I Hearings, supra* note 3 (statement of Senator Robert Bennett).

100. *Id.*

101. *Id. But cf.,* Shmuel Vasser, *Derivatives in Bankruptcy*, 60 BUS. LAW. 1507, 1509-1511 (describing the public policy Congress explicitly pursued in the 2005 amendments to the Bankruptcy Code, choosing to exempt derivatives contracts from the automatic stay in bankruptcy in order to protect financial institutions and financial markets).

102. *See Panel I Hearings, supra* note 3 (statement of Senator Robert Bennett).

103. *Id.* (statement of Timothy Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York).

104. FINANCIAL ACCOUNTING STANDARDS BOARD, *Statement of Financial Accounting Standards No. 157* (FASB 157), Sept. 2006, at 2, available at <http://www.fasb.org/st/index.shtml> ("The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability . . . This Statement emphasizes that fair value is a market-based measurement, not an entity-specific



the already thin market for those assets freezes up and only a handful of transactions occur at extremely depressed prices,”<sup>105</sup> those prices still form the market by which institutions must value similar assets on their own books. As a result, these institutions would write down assets and suffer attendant losses on the income statement.<sup>106</sup> In turn, equity cushions, already wildly insufficient at many institutions, would be crushed, creating the need to raise capital.<sup>107</sup> Shareholders would be diluted and lenders would require more collateral be posted: “[A] self-reinforcing downward spiral[.]”<sup>108</sup>

The regulators described a bifurcated rationale underlying their decision to intervene in the Bear collapse:<sup>109</sup> first, they defined the particular position occupied by Bear in the financial system; and second, they evaluated the economic stability of the financial system and concluded Bear was too interconnected and the financial system too disorderly to absorb the bankruptcy fluidly.<sup>110</sup> Apart from semantics, it is plain that the “too interlinked to fail” rationale articulated does not meaningfully depart from the “too big to fail doctrine” (TBTF).<sup>111</sup> Arguably, the “implicit subsidy”<sup>112</sup> that has historically benefited large banks in the capital markets and encouraged increased risk taking pursuant to the TBTF doctrine, had also been imputed to securities firms, like Bear.<sup>113</sup> In one sense, at least, the Bear bailout was preordained.<sup>114</sup>

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measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability.”). *But see* William M. Issac, *How to Save the Financial System*, WALL ST. J., Sept. 19, 2008, at A23 (questioning FASB 157 and offering a compelling argument against mark to market accounting); *see also* Crouhy, Jarrow & Turnbull, *supra* note 5.

105. Issac, *supra* note 104.

106. *See Panel I Hearings, supra* note 3 (statement of Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York).

107. *See id.*; Wilmarth, *supra* note 44.

108. *See Panel II Hearings, supra* note 82 (statement of Timothy Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York).

109. *See Geithner Testimony, supra* note 20.

110. *See Panel I Hearings, supra* note 3 (statement of Ben Bernanke, Chairman, Federal Reserve Board of Governors) (explaining the regulators’ specific economic arguments for the necessity of action).

111. Wilmarth, *supra* note 44, at 300-313 (giving the history of the TBTF doctrine and its troubling implications for the financial system).

112. *Id.* at 301.

113. Todd, *supra* note 12, at 20 (arguing that the FDICIA amendment to § 13(3) of the Federal Reserve Act changed the rules for securities firms in terms of risk

## III. LEGAL MOORINGS OF FED ACTION

A. *Organization of the Federal Reserve System*

"The Federal Reserve System is the central bank of the United States. It was founded by Congress in 1913 to provide the nation with a safer, more flexible, and more stable monetary and financial system."<sup>115</sup> The System has three main parts, the Board of Governors (the Board), the Reserve Banks and the Federal Open Market Committee (FOMC).<sup>116</sup>

The Board is a federal agency comprised of seven members serving fourteen year terms.<sup>117</sup> Members are appointed by the President and confirmed by the Senate. The Chairman and Vice Chairman of the Board are appointed and confirmed to four year terms and are typically selected from the existing members of the board.<sup>118</sup>

The Reserve banks are organized by geographic districts in a manner similar to the Federal court system.<sup>119</sup> Together, the Board and the Reserve Banks are responsible for "supervising and regulating certain financial institutions and activities, for providing banking services to depository institutions and the federal government, and for ensuring that consumers receive adequate information and fair treatment in their business with the banking system."<sup>120</sup> Depository institutions must maintain balances at the

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management and financing options); *see also* Wilmarth, *supra* note 44, at 225 (discussing the problems of "moral hazard" and "regulatory forbearance" within the financial system vis-à-vis large financial institutions).

114. *Id.* at 22 ("[C]ontinued observance of a too-big-to-fail doctrine in this case, for nonbanks), and the absence of adequate procedural safeguards could increase Reserve Banks' and, ultimately, taxpayers' losses from § 13(3) lending activities in the future. Furthermore, greater potential access to the federal financial safety net could boost the risk-taking incentives for nonbanks, thereby increasing the probabilities that they will request discount window lending during financial emergencies.").

115. PURPOSES & FUNCTIONS, *supra* note 5, at 1.

116. *Id.*

117. *Id.* at 4 (explaining that appointments are staggered and a Board member may (and usually does) leave the position before expiration).

118. *Id.* (explaining that the directors may also "be simultaneously appointed to the Board.").

119. *Id.*

120. *Id.* at 3. In particular, the Reserve Banks "carry out a variety of System functions, including operating a nationwide payments system, distributing the

Reserve Banks or keep a percentage of deposits as cash in that institution's vault.<sup>121</sup>

These balances are "actively trade[d]. . .with each other, usually overnight, on an uncollateralized basis"<sup>122</sup> in what is called the "federal funds market."<sup>123</sup> Demand is driven by the depository institutions' need to maintain sufficient reserve balances in light of variable withdrawals by their own depositors.<sup>124</sup> Based on this variable demand curve, supply is constantly manipulated by the FOMC to maintain a targeted rate of trading called the federal funds rate (fed funds rate).<sup>125</sup> The FOMC votes periodically to decide the "target range" for the fed funds rate.<sup>126</sup>

The FOMC is a committee formed by the Board and five Reserve Bank presidents, one of which is always the President of the Reserve Bank of New York.<sup>127</sup> Under ordinary economic conditions, the FOMC controls supply in the federal funds market primarily using its "open market operations."<sup>128</sup> Open market operations are the buying and selling of U.S. Treasury securities ("Treasuries") by the Fed,<sup>129</sup> on an "outright (also called

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nation's currency and coin, supervising and regulating member banks and bank holding companies, and serving as banker for the U.S. Treasury." Fed revenues are principally drawn from interest on U.S. government securities, interest on foreign currency investments and interest on loans made to depository institutions. Net income flows to the U.S. Treasury. *See id.* at 11.

121. PURPOSES & FUNCTIONS, *supra* note 5, at 30.

122. *Id.*

123. *Id.*

124. A depository institution must have "vault cash" equal to a fraction of its deposits as set by the Federal Reserve. This level is called the "required reserve balance." In addition, depository institutions will maintain a "contractual clearing balance" beyond the "required reserve balance" as a cushion against unexpected transactions. While the institutions earn no interest on their required balances, they do earn interest on the clearing balance. Likewise, institutions may hold another level of protection against unexpected withdrawals called "excess reserve balances." Individually and collectively these balances fluctuate daily. *See id.* at 28-32.

125. *Id.* at 32; *see supra* note 32 and accompanying text.

126. *Id.* at 35.

127. PURPOSES & FUNCTIONS, *supra* note 5, at 11, 36-38.

128. *See id.* at 45 (noting that the Fed's lending through the discount window becomes a more important monetary tool in times of economic stress); *see also* Fettig, *supra* note 9 ("We should also note here that by the 1930s the discount window had given way to open market operations as the preferred method of controlling the nation's supply of credit[.]").

129. *Id.* at 35, 37 (stating that the FOMC directs the New York Fed to conduct open market operations).

permanent) basis or temporarily in the form of repurchase agreements.”<sup>130</sup> Open market operations are actually somewhat more complex, but the underlying principle is relatively straightforward.<sup>131</sup> The Fed expands and contracts the money supply by buying and selling Treasuries, which are debt securities.<sup>132</sup> When the Fed sells securities, the money supply shrinks because the purchase price is taken out of the money supply.<sup>133</sup> When the Fed buys back securities the money supply increases by the amount paid out by the Fed for the securities.<sup>134</sup> Decreasing the money supply increases the fed funds rate; increasing the money supply decreases the fed funds rate.<sup>135</sup>

In times of extraordinary stress, the Fed uses a second tool, “[secured] lending at the discount window” to affect monetary policy.<sup>136</sup> This mechanism “serves two primary functions:” first, it complements open market operations in achieving the target federal funds rate by making Federal Reserve balances available to depository institutions when the supply of balances falls short;<sup>137</sup> second, “[i]t also serves as a backup source of liquidity for individual depository institutions.”<sup>138</sup> Historically, the discount window is the tool by which the Fed fulfills its role as “lender of last resort” in times of financial stress.<sup>139</sup>

Direct lending typically proceeds under “primary, secondary, and seasonal credit programs”<sup>140</sup> to depository institutions. However, depository institutions avoid borrowing through these programs because of a negative signaling effect in the markets.<sup>141</sup> A large downward reaction in a firm’s stock price

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130. *Id.* at 32.

131. *See infra* notes 132-135 and accompanying text.

132. *See* PURPOSES & FUNCTIONS, *supra* note 5, at 37-40.

133. *Id.*

134. *Id.*

135. *Id.*

136. *Id.* at 45.

137. PURPOSES & FUNCTIONS, *supra* note 5.

138. *Id.*

139. *See Panel I Hearings, supra* note 3 (statement of Timothy Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York).

140. PURPOSES & FUNCTIONS, *supra* note 5, at 46-49 (distinguishing these programs by purpose and spread over the fed funds rate).

141. Sudeep Reddy, *Fed Extends Lending Programs as Threats Persist: Move Reflects Worry Over ‘Fragile’ State of Financial Market*, WALL ST. J., July 31, 2008, at

may even offset the immediate liquidity provided by the credit.<sup>142</sup> The Fed instituted the Term Auction Facility Program (TAF) in December 2007, as a mechanism to counteract this dynamic and encourage borrowing among depository institutions.<sup>143</sup> Non-depository institutions may also borrow at the discount window in extreme conditions.<sup>144</sup> Prior to March 2008, however, the Fed had not made the finding necessary under the statute to lend to institutions other than banks since the Great Depression.<sup>145</sup> Even then, “[j]ust 123 loans were made under the unusual and exigent provision over four years in the 1930s by the Federal Reserve, totaling about \$1.5 million.”<sup>146</sup> Given the reluctance of depository institutions to borrow at the discount window, it is not surprising that a non-depository institution would face even greater stigma.<sup>147</sup>

*B. Statutory Authority*

Speaking before the Economic Club of New York just after the Bear bailout, Former Federal Reserve Chairman Paul A. Volcker<sup>148</sup> offered the following critique:

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A3 (“That program was created as an alternative to the Fed’s discount window, which is generally used by banks for last-minute funding needs but can carry a stigma because an institution fears being seen as troubled.”).

142. *Id.*

143. See Press Release, Bd. of Governors of the Fed. Reserve Sys., Term Auction Facility, (Dec. 12, 2007), available at <http://www.federalreserve.gov/newsevents/press/monetary/20071212a.htm> (describing the TAF).

144. 12 U.S.C. § 343 (2006).

145. Todd, *supra* note 12, at 18 n.14 (“The Board has reactivated Section 13(3) rarely since the 1930s, but this emergency lending authority has not actually been used since 1936. It was activated for savings and loan associations, mutual savings banks, and nonmember commercial banks in 1966 and 1969.” (citation omitted)); PURPOSES & FUNCTIONS, *supra* note 5, at 46 (stating that the Fed has not lent to a non-depository institutions since the 1930s).

146. *Hoover-Era Law Was Behind Fed-Treasury Debates*, WALL ST. J., Nov. 9, 2008, <http://blogs.wsj.com/economics/2008/11/09/hoover-era-law-was-behind-fed-treasury-debates/>.

147. See Meena Thiruvengadam, *Investment Bank Borrowing at Discount Window Hits Record*, WALL ST. J., Sept. 26, 2008, <http://online.wsj.com/article/SB122237806611776365.html> (noting that investment banks refused to use the “primary dealer credit facility” created specifically for broker-dealers after the collapse of Bear Stearns, until they were pushed to the brink).

148. Volcker has been selected by President Barack Obama as a top economic adviser in the new administration. See *Government Moves Rally Stocks*, WASH. POST, Nov. 30, 2008, at F06.

[T]he Federal Reserve judged it necessary to take actions that extend to the very edge of its lawful and implied powers . . . The extension of lending directly to non-banking financial institutions – while under the authority of nominally “temporary” emergency powers will surely be interpreted as an implied promise of similar action in times of future turmoil. What appears to be in substance a direct transfer of mortgage and mortgage-backed securities of questionable pedigree from an investment bank to the Federal Reserve seems to test the time honored central bank mantra in times of crisis – “lend freely at high rates against good collateral” – tested to the point of no return.<sup>149</sup>

Volcker’s commentary is particularly helpful in framing the statutory analysis set forth below because it illustrates how monetary policy precedent can be confused with the Fed’s legal authority.<sup>150</sup> This is not surprising given the “reflexive” nature of the Fed’s relationship with financial markets.<sup>151</sup>

Financial markets are forward-looking and participants ascribe value to assets through the exchange of information.<sup>152</sup> In fact, federal securities laws require transparency and disclosure principally to facilitate the flow of information among market participants.<sup>153</sup> As a market participant itself, the Fed must act

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149. Paul A. Volcker, Former Chairman, Federal Reserve System, Keynote Address at the 395th Meeting of the Economic Club of New York 2 (Apr. 8, 2008) [hereinafter Volcker Speech] (transcript available at [http://econclubny.org/files/Transcript\\_Volcker\\_April\\_2008.pdf](http://econclubny.org/files/Transcript_Volcker_April_2008.pdf)).

150. See *infra* notes 152-169 and accompanying text.

151. See Soros, *supra* note 21, at 50 (“[T]here is a two-way connection between thinking and reality which, when it operates simultaneously, introduces an element of uncertainty in to the participants’ thinking and an element of indeterminacy into the course of events.”).

152. Christopher Paul Saari, *The Efficient Capital Market Hypothesis, Economic Theory and The Regulation of The Securities Industry*, 29 STAN. L. REV. 1031, 1031 (1977) (defining the “Efficient Capital Market Hypothesis.”).

153. Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 382-383 (2005) (“Instead, the 1933 Act was premised solely on a system mandating full and fair disclosure to investors, under the guidance of a

with a level of consistency in order to pursue its stated goals of “maximum employment, stable prices, and moderate long-term interest rates.”<sup>154</sup> Over time, the role of the Federal Reserve has been defined by the precedent of its own actions.<sup>155</sup> This effect, which has real and powerful implications in the markets, is far different, however, than the boundaries of Fed authority circumscribed by law.<sup>156</sup>

The Fed’s authority to lend to a non-depository institution comes from § 13(3) of the Federal Reserve Act:

In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d) of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal reserve bank: *Provided*, That before discounting any such note, draft, or bill of exchange for an individual or a partnership or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and

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federal agency, as a mechanism for permitting informed investment decisions. Disclosure rather than a merit approach remains the regulatory philosophy of the federal securities laws today.”).

154. PURPOSES & FUNCTIONS, *supra* note 5, at 15.

155. *Cf.*, *Ip*, *supra* note 5 (understanding the significance of Fed action in terms of how often a given action has been taken, not whether legal authority for the action exists).

156. 12 U.S.C. § 343 (2006).

regulations as the Board of Governors of the Federal Reserve System may prescribe.<sup>157</sup>

The Federal Reserve Bank of New York expressly cited this provision as authority for the loans made on March 14 and March 16, 2008, respectively.<sup>158</sup> The statute provides that certain conditions be met in order for the Fed to properly extend credit to a non-depository institution.<sup>159</sup> Monetary policy precedent may distort the stringency of the legal standard demanded by these conditions.<sup>160</sup> The Bear bailout illustrates how, in practice, the conditions on lending to a non-depository institution tend to dovetail so that the legal standard is actually a quite low threshold relative to monetary policy constraints.<sup>161</sup>

Section 13(3) first requires that “unusual and exigent circumstances”<sup>162</sup> be present in order for the Board to consider extending credit. “Unusual” and “exigent” are not defined terms under the statute.<sup>163</sup> Webster’s defines “unusual” to be “uncommon” or “rare”<sup>164</sup> and “exigent” as “requiring immediate aid or action.”<sup>165</sup> Neither generic definition provides much specificity, which suggests the interpretation was left open to the Board’s discretion.<sup>166</sup> Chairman Bernanke offered this reading of the provision in his testimony before Congress: “We have a very high bar for unusual and exigent, so this is twice in 75 years that

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157. *Id.*

158. *See Panel I Hearings, supra* note 3 (statement of Timothy Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York); Press Release for JPMorgan Facility, *supra* note 94 (“The Federal Reserve loan is being provided under the authority granted by section 13(3) of the Federal Reserve Act. The Board authorized the New York Fed to enter into this loan and made the findings required by section 13(3) at a meeting on Sunday, March 16, 2008.”).

159. 12 U.S.C. §343 (2006).

160. *See supra* notes 151-156 and accompanying text.

161. *See infra* notes 162-205 and accompanying text.

162. 12 U.S.C. § 343 (2006).

163. 12 U.S.C. § 221 (2006).

164. Merriam-Webster’s Online Dictionary, <http://www.merriam-webster.com/dictionary/unusual> (last visited Jan. 26, 2009).

165. *Id.*, <http://www.merriam-webster.com/dictionary/exigent> (last visited Jan. 26, 2009).

166. *C.f.,* Fetting, *supra* note 9 (noting President Hoover’s expectation that this emergency provision would be limited to times of crisis was not unanimous and there was ongoing debate at the time of the 1932 amendment as to the proper role of the Fed in the nation’s economy).



we've used this – we've applied this power.”<sup>167</sup> Bernanke's subsequent testimony makes clear the Board interpreted the “unusual and exigent” standard in light of economic considerations.<sup>168</sup> Therefore, under the assumption that the Board's interpretation controls, the “high bar” that must be surmounted to find “unusual and exigent circumstances” is to be contemplated on the basis of economics and monetary policy rather than law.<sup>169</sup>

Next, “the affirmative vote of not less than five members”<sup>170</sup> is required under the statute before credit may be extended. Normally, a vote by five members would be a super-majority because there are seven members on the Board.<sup>171</sup> In this instance, a quorum was never reached with respect to the March 14 decision because there were two vacant seats on the Board and one member was traveling.<sup>172</sup> If at least two members are present, then a unanimous vote among those present is sufficient under an exception provided for in § 11 of the Act.<sup>173</sup> This provision does require one incremental condition be met before the exception can apply, “action on the matter is necessary to prevent, correct, or mitigate serious harm to the economy or the stability of the financial system of the United States.”<sup>174</sup> This extra stipulation is superfluous under the Fed's current interpretation of “unusual and exigent circumstances.”<sup>175</sup> Geithner's testimony is illustrative: “It's the combination of [Bear's intermediary role and the circumstances prevailing in markets at the time] that made it so *exceptionally risky for the U.S. economy*.”<sup>176</sup> Furthermore, as a

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167. *Panel I Hearings, supra* note 3 (statement of Ben Bernanke, Chairman, Federal Reserve Board of Governors).

168. *Id.* (“In thinking about [the standard], we thought not only about the interconnectedness of Bear Stearns and the issues we've raised, but also about the situation in the financial markets more generally . . . But given the weakness and the fragility of many markets, we thought the combination was indeed unusual and exigent.”).

169. *Id.*

170. 12 U.S.C. § 343 (2006).

171. *See supra* Part III(A).

172. *Ip, supra* note 5.

173. 12 U.S.C. § 248(r)(2)(A)(i)-(iii) (2006).

174. *Id.* at § (r)(2)(A)(ii)(II).

175. *See supra* notes 162-169 and accompanying text.

176. *Panel I Hearings, supra* note 3 (statement of Timothy Geithner, President and

matter of statutory construction, the absence of this language in § 13(3) suggests that “unusual and exigent circumstances” does not contemplate this incremental restriction.<sup>177</sup> By inference, the legal basis for “unusual and exigent circumstances” may be even less stringent than the Fed’s monetary policy would indicate.<sup>178</sup>

Section 13(3) expressly provides for credit to be extended in the form of a “discount.”<sup>179</sup> The consequence of this language arises from an esoteric distinction between “advances” and “discounts,” the two mechanisms by which the Fed extends credit.<sup>180</sup> With an advance, “the depository [institution] issues its own promissory note to the Federal Reserve, and the private-sector security is the collateral.”<sup>181</sup> “In the discounting method of lending, a bank would present a short-term business loan or other asset meeting the type and maturity specifications of the Federal Reserve Act, and the Federal Reserve Bank would extend credit in an amount reflecting the value of the asset at maturity minus a ‘discount’ based on the Federal Reserve’s discount rate and the time until maturity of the asset.”<sup>182</sup>

For most of the last century, advances have been the only type of credit offered through the discount window to depository institutions because they offer several advantages over discounts.<sup>183</sup> First, they provide a more straightforward credit mechanism because they are essentially secured loans.<sup>184</sup> Second, when lending to depositories, the criteria defining acceptable collateral is much broader under an advance than it is under a discount.<sup>185</sup>

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Chief Executive Officer, Federal Reserve Bank of New York) (emphasis added).

177. See 12 U.S.C. §§ 248(r)(1)-(2)(b), 343 (2006).

178. See *supra* notes 151-169 and accompanying text.

179. 12 U.S.C. § 343 (2006).

180. See David H. Small & James A. Clouse, *The Limits the Federal Reserve Act Places on the Monetary Policy Actions of the Federal Reserve*, 19 ANN. REV. BANKING L. 553, 560-563 (2000).

181. *Id.* at 555.

182. Steven R. Blau, Book Note, *The Federal Reserve and European Central Bank as Lenders-of-Last-Resort: Different Needles in Their Compasses*, 21 N.Y. INT’L L. REV. 39, 51 n.84 (omitting citation); see also Small & Clouse, *supra* note 179, at 559 n.26 (providing a historical analysis of the precise differences between discounts and advances).

183. See Small & Clouse, *supra* note 180, at 561.

184. *Id.*

185. *Id.* at n.31.

Collateral for an advance in this context need only be “satisfactory” to the Reserve Bank extending credit.<sup>186</sup>

By contrast, eligible collateral to secure a discount to a depository institution is far more restricted.<sup>187</sup> Collateral has to satisfy the “real bills”<sup>188</sup> doctrine under § 13(2).<sup>189</sup> “In essence, the only acceptable collateral [under this doctrine is] near substitutes for cash.”<sup>190</sup> Under § 13(3), the Fed may only extend credit in the form of a discount.<sup>191</sup> Thus, the real bills doctrine is a very restrictive condition embedded within the provision.<sup>192</sup>

However, Section 473 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) amended § 13(3) of the Federal Reserve Act, negating the force of the real bills doctrine.<sup>193</sup> After the amendment, the controlling language became “*or otherwise* secured to the satisfaction of the Federal reserve bank.”<sup>194</sup> The Fed was effectively granted complete discretion to accept any types of collateral for a discount made in “unusual and exigent circumstances.”<sup>195</sup>

Section 13(3) also expressly requires a showing that “such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions.”<sup>196</sup> According to testimony by New York Fed President Geithner, this showing is presumed to be indistinct from the finding of “unusual and exigent circumstances.”<sup>197</sup> To

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186. *Id.* at 561 (opining that “even equity shares” would be acceptable under this standard).

187. *See infra* notes 188-192 and accompanying text.

188. *Id.* at 573.

189. 12 U.S.C. § 343 para. 1 (2006).

190. Todd, *supra* note 12, at 18.

191. 12 U.S.C. § 343 (2006).

192. *See* Todd, *supra* note 12, at 19 (“[T]he reason why the Reserve Banks were prohibited from extending credit on stocks and bonds [under Section 13] was that the [Reserve] Banks were intended to assist commercial banking and not investment banking[.]”).

193. 12 U.S.C. § 343 historical and statutory notes (2006); *see also* Todd, *supra* note 12, at 19.

194. 12 U.S.C. § 343 (2006).

195. *See* Small & Clouse, *supra* note 180, at 15 & n.32.

196. 12 U.S.C. § 343 (2006).

197. *See Geithner Testimony*, *supra* note 20 (“The Board of Governors is empowered to authorize a Federal Reserve Bank like the New York Fed to lend to a corporation . . . in extraordinary circumstances under which there is evidence that the corporation cannot ‘secured adequate credit accommodations from other banking

incorporate this condition into the interpretation of “unusual and exigent circumstances” is reasonable because it would make little sense for the Fed to provide credit to such an institution otherwise.<sup>198</sup> Furthermore, the psychology of the markets seems to ensure that this condition would otherwise be satisfied.<sup>199</sup>

Finally, judicial precedent has removed the Fed’s judgments around monetary policy from judicial oversight.<sup>200</sup> In particular, the courts have taken the position that the effectiveness of monetary policy would be subverted if it were to be second-guessed by judicial review.<sup>201</sup> Given this position by the courts, the legality of the Fed’s actions on March 14 and March 16, 2008 related to the bailout of Bear is demonstrated under the statutory analysis laid out above.<sup>202</sup> Section 13(3) grants the Fed expansive authority in “unusual and exigent circumstances,”<sup>203</sup> without requiring a stringent legal standard be met in order to respond to crises.<sup>204</sup> In practice, the Fed is more constrained by market psychology that demands a consistent monetary policy than by statutory limitations on its authority.<sup>205</sup>

#### IV. SECTION 13(3) IS A DOUBLE-EDGED CATCH-22<sup>206</sup>

The Fed is charged with conducting the nation’s monetary policy, overseeing certain financial institutions and managing the

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institutions.”).

198. *See id.*

199. *See supra* notes 140-147 and accompanying text.

200. *Raichle v. Fed. Reserve Bank of New York*, 34 F.2d 910, 915 (2d Cir.1929) (“It would be an unthinkable burden upon any banking system if its open market sales and discount rates were to be subject to judicial review.”).

201. *See Huntington Towers, Ltd. v. Franklin Nat’l Bank*, 559 F.2d 863, 868 (2d Cir. 1977) (“[T]he granting of rescue funds to [Franklin National Bank] by the [Federal Reserve Bank] were exercises of judgment by the public officials concerned and were well within their competence and authority. Absent clear evidence of grossly arbitrary or capricious action on the part of either or both of them -- a factor which does not appear to be present here -- it is not for the courts to say whether or not the actions taken were justified in the public interest, particularly where it vitally concerned the operation and stability of the nation’s banking system.”).

202. *See supra* notes 149-199 and accompanying text.

203. 12 U.S.C. § 343 (2006).

204. *See supra* notes 149-199 and accompanying text.

205. *Id.*

206. *Heller, supra* note 1.

financial system to prevent systemic risk in financial markets.<sup>207</sup> In order to carry out these duties in times of crisis, the Fed acts as the “lender of last resort.”<sup>208</sup> Given this express duty, the existence of an emergency provision like § 13(3) in the statutory scheme is essential.<sup>209</sup> Ironically, however, the presence of § 13(3) and the Fed’s proper exercise of authority pursuant to § 13(3) creates a double-edged catch-22 that may ultimately challenge the usefulness of the provision, if not its legality.<sup>210</sup> The Bear bailout is instructive.<sup>211</sup>

First, the mere presence of § 13(3) may help produce the very circumstances that require its use.<sup>212</sup> Market participants make decisions based upon the information available to them.<sup>213</sup> It has been argued that traditional banks have benefited from an “implicit subsidy” under the TBTF doctrine because the market discounts risk for these institutions to reflect the expectation that the government would not allow any of these institutions to fail.<sup>214</sup> These institutions have reacted to the subsidy with greater risk-taking and increased leverage.<sup>215</sup> The market likely incorporated the practical meaning of the 1991 FDICIA amendment to § 13(3), which negated collateral restrictions on emergency credit by the Fed, into risk assumptions for major securities firms, like Bear.<sup>216</sup> Thus, while § 13(3) was amended precisely to help avert financial panic given the prospect of a securities firm’s failure,<sup>217</sup> the

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207. PURPOSES & FUNCTIONS, *supra* note 5, at 1.

208. *Geithner Testimony*, *supra* note 20 (“A driving force behind Congress’ creation of the Federal Reserve System in 1914 was its recognition of the need for a public institution to perform the role of lender of last resort.”).

209. *See* Blau, *supra* note 182, at 44 (“[The Fed] has clear and express statutory authority to lend to banks for the sake of their stabilization.”).

210. *See infra* notes 212 – 234 and accompanying text.

211. *Id.*

212. *See infra* notes 213-218 and accompanying text.

213. *See* Saari, *supra* note 152, at 1031.

214. Wilmarth, *supra* note 44, at 301.

215. *Id.* (noting the implicit subsidy has helped keep the cost of borrowing for these institutions artificially low).

216. Todd, *supra* note 12, at 20-21 n.21.

217. *Id.* at 20 (statement of Sen. Christopher Dodd, D-CT) (“It [FDICIA] also includes a provision I offered to give the Federal Reserve greater flexibility to respond in instances in which the overall financial system threatens to collapse. My provision allows the Fed more power to provide liquidity, by enabling it to make fully secured loans to securities firms in instances similar to the 1987 stock market crash.”).

amendment may have induced the set of circumstances demanding its use.<sup>218</sup>

Given these assumptions, Bear's collapse may be viewed as a somewhat predictable outcome.<sup>219</sup> Likewise, the Fed's response at the point of collapse was predictable insofar as the magnitude of the situation left officials with no choice but to act.<sup>220</sup> Yet, subsequent events in the unfolding crisis presented regulators with a strikingly similar situation when Lehman Brothers (Lehman) faced a parallel collapse in September 2008.<sup>221</sup> The Fed declined to bail out Lehman<sup>222</sup> and the firm filed for bankruptcy protection on September 15, 2008 in the largest Chapter 11 filing in U.S. history.<sup>223</sup> The bankruptcy filing immediately sent the financial system into a tailspin, convincing the Fed and Treasury to bail out American International Group Inc. (AIG) with an \$85 billion loan just two days later.<sup>224</sup> In less than two weeks, Congress passed the

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218. Todd, *supra* note 12, at 20-21 ("The extension of the federal financial safety net to nonbanks may increase the probability of market liquidity crises that appear to require Federal Reserve emergency lending. This could happen during periods of market stress if the costs of risky investment and funding strategies are not fully borne by the managers and shareholders of nonbank firms, but instead are perceived as being partially or fully underwritten by U.S. taxpayers."). *But see* Ferguson, *supra* note 2 ("This hunt for scapegoats is futile. To understand the downfall of [the global financial system], you need to take several steps back and locate this crisis in the long run of financial history. Only then will you see that we have all played a part in this latest sorry example of what the Victorian journalist Charles Mackay described in his 1841 book, 'Extraordinary Popular Delusions and the Madness of Crowds.'").

219. Todd, *supra* note 12, at 20-21.

220. *See Panel I Hearings, supra* note 3 (statement of Ben Bernanke, Chairman, Federal Reserve Board of Governors) (explaining the regulators' specific economic arguments for the necessity of action).

221. *See generally* Andrew Ross Sorkin, *How the Fed Reached out to Lehman*, DEALBOOK.BLOGS.NYTIMES.COM, Dec. 16, 2008, [http://www.nytimes.com/2008/12/16/business/16sorkin.html?\\_r=1](http://www.nytimes.com/2008/12/16/business/16sorkin.html?_r=1).

222. Derek Kravitz, *Behind-Scenes Frenzy Led to Lehman Collapse*, WASH. POST, Sept. 16, 2008, [http://voices.washingtonpost.com/washingtonpostinvestigations/2008/09/behind-the-scenes\\_frenzy\\_led\\_u.html](http://voices.washingtonpost.com/washingtonpostinvestigations/2008/09/behind-the-scenes_frenzy_led_u.html) ("Paulson was not inclined to help save Lehman after similar moves with Fannie Mae, Freddie Mac and Bear Stearns. The Wall Street Journal reported that Paulson felt such a buyout 'would create a terrible precedent.'").

223. *See, e.g.,* Sorkin, *supra* note 221 ("But no one, least of all government officials, has fully explained why Lehman, one of the grand old names of Wall Street, was allowed to fail while so many others were rescued. Many people, at least on Wall Street, have come to view the decision to let Lehman die as one of the biggest blunders in this whole financial crisis. Christine Lagarde, France's finance minister, called the decision 'a genuine error.'").

224. Matthew Karnitschnig, Deborah Solomon, Liam Pleven & Jon E. Hilsenrath, *U.S. to Take Over AIG in \$85 Billion Bailout; Central Banks Inject Cash as Credit*

Emergency Economic Stabilization Act of 2008 which included the \$700 billion Troubled Asset Relief Program (TARP) to shore up the balance sheets of financial institutions.<sup>225</sup>

On first blush, the Lehman collapse reveals an ad hoc policy<sup>226</sup> that developed once the emergency powers were invoked—Lehman faced remarkably similar circumstances to those faced by Bear in March 2008, yet the Fed responded in exactly opposite ways.<sup>227</sup> At a deeper level, however, the near apocalyptic effects of the Lehman bankruptcy on the global financial system demonstrate how truly constrained regulators were by market expectations once the Fed initially chose to act to save Bear under § 13(3).<sup>228</sup> The market forced the Fed to extend credit to more and more institutions as the crisis continued to deepen.<sup>229</sup>

This pattern raises the second catch-22 of § 13(3). While the Fed's initial response to rescue Bear were legal under § 13(3),<sup>230</sup> subsequent actions raise questions about whether the Fed

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*Dries Up*, WALL ST. J., Sept. 16, 2008, at A1.

225. Christopher J. Dodd, D-CT, Chairman, U.S. S. Comm. On Banking, Housing, and Urban Affairs, *Summary of the "Emergency Economic Stabilization Act of 2008,"* available at [http://banking.senate.gov/public/\\_files/latestversionEESASummary.pdf](http://banking.senate.gov/public/_files/latestversionEESASummary.pdf); see also, Mark Landler & Edmund L. Andrews, *For Treasury Dept., Now Comes Hard Part of Bailout*, N.Y. TIMES, Oct. 3, 2008, at A1 (discussing the practicalities of trying to implement TARP successfully).

226. See *Fed Chairman's Q&A on Financial Crisis*, WALL ST. J., Oct. 16, 2008, <http://online.wsj.com/article/SB122409761899937343.html> [hereinafter *Bernanke Q&A*] ("In Bear Stearns and in AIG and Lehman and in all of the other things we've dealt with, there is no such system, there is no resolution system. There is no set of rules, there's no funding, there's no authorizations. So that everything that was done with those nonbank firms had to be done in a very ad hoc way."); accord Karnitschnig, Solomon, Plevin & Jon E. Hilsenrath, *supra* note 224 (describing ten days in which the Fed and Treasury saved Fannie Mae and Freddie Mac on Sept. 6, refused to bail out Lehman over the weekend of Sept. 12-14, and then elected to save AIG on Sept. 16).

227. *Bernanke Q&A*, *supra* note 226 ("Lehman was not allowed to fail that in the sense there was some choice being made . . . The Federal Reserve's ability to lend which was used in the Bear Stearns case, for example, requires that adequate collateral be posted so that we are not taking credit risk, we are lending against collateral. In this case that was impossible. There simply wasn't enough collateral to support the lending.").

228. See *Panel I Hearings*, *supra* note 3 (statement of Senator Dodd, D-CT) ("[The Fed is required to act to] prevent a systemic collapse of financial markets.").

229. See, e.g., *Bernanke Q&A*, *supra* note 226 (describing how the financial system had become organized such that many institutions had become "too big-to-fail.").

230. See *supra* notes 149-205 and accompanying text.

continued to meet the “unusual” standard required under § 13(3).<sup>231</sup> It seems clear that § 13(3) was a loophole provision included in the Federal Reserve Act to help the Fed move swiftly and decisively in response to significant threats; however, it is unlikely that it was meant to form the basis of Fed action over a long horizon.<sup>232</sup> At some point, continuing circumstances cease to be unusual.<sup>233</sup> At what point?

This is precisely the type of statutory construction question the judiciary often resolves, yet the courts are admittedly ill suited to decide issues inextricably linked to monetary policy.<sup>234</sup> Thus, it will ultimately fall to the Congress to resolve this thorny issue by crafting law that preserves the flexibility necessary for an effective monetary policy without that flexibility becoming self-defeating in times of crisis.<sup>235</sup>

THOMAS O. PORTER, II

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231. 12 U.S.C. § 343 (2006); *see also supra* notes 162-169 and accompanying notes (analyzing the legal standard for “unusual and exigent circumstances”).

232. *See* Fettig, *supra* note 9 (stating that the 1932 Amendment was meant to have narrow applicability).

233. *Panel I Hearings, supra* note 3 (statement of Ben Bernanke, Chairman, Federal Reserve Board of Governors) (“However since our lending authority is only for emergencies, we will have to take this window back. We’ll have to close it when conditions are normalized.”).

234. *See* Raichle v. Fed. Reserve Bank of New York, 34 F.2d 910, 915 (2d Cir. 1929).

235. *See supra* notes 207-234 and accompanying text.



